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Weekly Market Insights

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Tariffs Roil the Market

Although two important economic releases came out this past week, investors fixated on the apparent failure of a trade deal between the United States and China.

The Dow 500 fell 2.12%, the S&P 500 was down 2.18% and the NASDAQ fell 3.03%. Although this past week was the worst equity performance in quite a while, investors should be comforted that all indexes ended the week on a significant upturn. The past week's market behavior reinforces some analysts' belief that the markets are being driven by short term traders. One reason we say investors should be a bit comforted by the late week strength is those traders apparently didn't want to enter the new week short, because there is a possibility that an agreement may be reached with China. This reinforces our view that the major cause of the downturn was the seeming collapse of trade talks and not fundamental economic weakness. This volatility may continue for some time, but if the fundamentals remain strong, we remain confident in the markets.

The two releases we want to address are April's CPI and the March Trade Gap. The April CPI monthly number was +0.319%, which is equal to a year over year gain of 2.0%. This should not strike fear into the hearts of investors. It is within the hoped for range of the Fed and poses no threat of higher interest rates.

March's Trade Gap was $50 billion. No great surprise there. Very little change. This release, just as the CPI, should be greeted by investors and government officials with a yawn. So why the market panic? It's the possible disappointments in the anticipated trade agreement and the imposition of new and higher tariffs.

Why do economists and politicians seem so far apart about trade deficits, trade barriers and tariffs? Almost all economists are for free trade, and reasonably unconcerned about trade deficits, while almost all politicians are leery of free trade, globalization and accompanying trade deficits.

We have written about this in the past, but it deserves repeating. Economists' reasoning is inspired by the brilliant economist David Ricardo's insights into international trade two centuries ago. His thesis is "Comparative Advantage." In its simplest form, it states that if each country produces what it does best, then the populations of each state will be better off. Almost all studies have proven this correct. Of course, there are occasional exceptions. So, why don't politicians jump on the band wagon and push for free trade? Here is where it gets interesting and why politicians ignore so many excellent recommendations from economists. Remember please that this is a simplification to make a point.

It is how each looks at the process. Economists think in terms of efficiency and the economy as a whole, while politicians think in terms of time and geography. Long term efficiency versus short term adjustment. Both have excellent points!

There are two economic terms we should know: static efficiency and dynamic adjustment. Static efficiency looks at the period when a policy is instituted and all adjustments have been made, and judges whether the economy is better off before or after. Politicians have to care about the dynamics. The dynamic adjustment addresses what happens while the economy is making the adjustment, who gets hurt and who gains. Many economists think in terms of static efficiency and are not concerned enough about the dynamic adjustment. This is a mistake and puts them at odds with politicians who must care about the dynamics and who gets hurt. Add to this, the short term nature of a politician's tenure and you see the problem. Economists must consider the adjustment period and work with politicians to smooth out the difficulties.

Will this trade crisis be settled? Yes, but who knows when. Investors investing in the United States have a great advantage. The U.S. economy will suffer far less than China's economy if it comes to a full-scale trade war.

China is far more dependent on international trade than the U.S. Although the sad truth is the suffering in the U.S. will not be evenly felt, certain sectors of the economy and country will suffer more than others. One of the main reasons politicians differ.

The Democratic primaries are fast approaching or, perhaps, already upon us. It will be interesting to see how the tariff and trade debate plays out. Trade is an area where many of the Democratic candidates, particularly the most progressive ones, agree or go even further than Mr. Trump's anti trade/globalization.

At least six candidates are openly against free trade. They are led by Bernie Sanders, Elizabeth Warren, Kirsten Gillibrand and Cory Booker.

At least nine can be considered to support free trade and a rule based system. They include: Steve Bullock, Julian Castro, John Delaney, Joseph Biden and Beto O'Rourke.

Interestingly, there are eight candidates who have not expressed an opinion.[1]

It should make for interesting debates.

None of this changes our view. Economy and the markets should be fine for six months and probably more. Investors should make sure their asset allocation is neutral.

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[1]Thanks to Gary Clyde Hufbauer and Euijin Jung both of the Peterson Institute for International Economics.